
The Risks and Rewards of BP's Russia Gamble

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For more than a decade Russia has tempted and, more often than not, burned foreign investors. The potential for profit from Russia's natural resources has always seemed so great, but the risks have always proved so high that foreign investors have taken to searching for a signal that the coast is finally clear. Is last week's decision by British Petroleum to invest \$6.8 billion to assume management control of Russia's third-largest oil company such a sign? Well, BP has been early (or wrong) before. Back in 1997, in its first foray into the new Russia, it bought a 10% stake in Sidanco, a Siberian oil company, and quickly lost it in an allegedly rigged bankruptcy procedure. Still, if BP can forgive and forget, then presumably others will follow its example. The size of the commitment—the largest single direct investment in Russia's post-Soviet history—is a vote of confidence in the Russian economy and the more stable economic and political environment being created under President Vladimir Putin.

More importantly, this deal sends a signal to other large potential foreign investors that the Russian government feels reasonably comfortable with foreign ownership of what, in the old days, used to be called “strategic assets.” Very few things are “strategic” anymore these days—some 15 years ago the Socialist government of Felipe Gonzales in Spain allowed Volkswagen to buy a 100% stake in SEAT, Spain's largest car manufacturer and there were no riots in the streets, no complaints about foreigners gaining control of the jewels in the crown of Spanish industry. Actually, the Spanish were happy that a money losing company, a black hole for the budget, would be finally run with German efficiency. In time, SEAT became a brilliant success story, a bountiful contributor of taxes to the Spanish budget. That the

Russian government has apparently also come to the view that in the age of one global economy it really does not matter very much who owns a company but rather how efficiently it is run, is good news for investors.

How much is US\$6.8 billion for Russia and how much more could one reasonably expect? And what does this investment say about the government's energy policy and its likely repercussions? Well, because US\$3.75 billion out of this total will be paid in BP shares over the next three years, a more accurate figure for the impact of this investment this year is the US\$3 billion to be paid in cash—still a sizable sum, close to 1% of Russia's GDP and roughly equivalent to what has been coming in on an annual basis during the last few years. Countries that have been successful in attracting foreign investment (Hungary, the Czech Republic, Chile, Brazil, the Baltics, several of the Asian “tigers”) have managed to absorb inflows in the region of 5-10% of GDP. In Russia this would translate into US\$17-35 billion per year. We are obviously not there yet. But, BP may be the beginning of a trend and this is significant indeed.

The government's energy strategy over the medium term is one central component of the continuing efforts to sustain the relatively good growth performance of the past several years. The issues here are many and interact at various levels. To begin with, there is a need to reduce the dependence of the Russian economy on oil, gas, and metals exports. Not only is this likely to remain a top policy priority for purely macroeconomic reasons, but there is also concern about undue dependence on the energy sector for structural reasons: it is leading to the continued concentration of economic

activity in commodity-based conglomerates—a chaebol form of capitalism which is likely to hamper growth.

A second set of issues stems from the nature of the relationship between OPEC and the Russian government, and the desire of the latter to project itself as a reliable energy supplier to the West, especially at a time when the West's—particularly the United States—political relations with some of the cartel's largest producers may be undergoing a shift that is likely to have beneficial effects for Russia's own interests.

On all these questions, the medium-term outlook for Russia is brightening up. First, Russian oil output is rapidly on the rise. In a recent issue of *Foreign Affairs* Edward Morse and James Richard argue persuasively that “Moscow is poised to assume a far more significant position in the world petroleum sector than ever before.” First, the Russian oil companies are engaged in a major process of restructuring and modernization, reinvesting their large profits to expand capacity and enhance efficiency; the BP investment is clearly a sign of this. Unlike their peers in many of the OPEC member countries, often dominated by state monopoly companies that bar foreign investment in the oil sector, Russia's oil companies are seeking to establish a presence among the world oil industry leaders, and are doing so against the background of a much stronger macroeconomy and a more stable political environment.

Second, the events of 11 September have precipitated a rethink within the US administration about the long-term political outlook for those countries in the Middle East that have been major suppliers of oil to the US market. In particular, Saudi Arabia, the country with the largest market share in the US (17% of total oil imports) and the world's largest oil exporter, has been at the centre of this review. Briefly stated, the view is that, within the next decade, the Middle East is likely to undergo major political commotions. The countries in the Gulf region have the highest rates of

population growth in the world and, hence, the most rapidly expanding labor forces. Unemployment rates have reached historically high levels, and serious structural rigidities in their economies have resulted in anemic growth rates and rapidly falling per capita incomes; in some cases, like Saudi Arabia's, the fall has been of catastrophic proportions. Rising social tensions, in the context of countries with unreformed political institutions, scant respect for human rights, and no experience of democracy to speak of, could well result in instability. Whether these emerging tensions then lead to evolutionary and largely peaceful changes (as happened in central and eastern Europe in the late 1980s/early 1990s) or are more violent in nature is not now clear. The point is that, from a strategic point of view, the new geopolitics of energy—as noted by Morse and Richard—creates a chance for Russia “to displace OPEC as the key energy supplier to the west.” The recent crisis in Venezuela—with Mr Chavez gradually taking the country to the edge of an economic and social implosion without precedent in one of Latin America's oldest and most stable democracies—can only have heightened the relative attractiveness of Russian oil.

The fact that the Russian public finances, and the economy more generally, are considerably less dependent on oil revenues than, say, Saudi Arabia, which is overwhelmingly oil-based, is likely to increase Russia's leverage in discussions with OPEC with regard to its “contribution” to stable prices in the oil markets and is likely to help Russian oil companies, as they contemplate partnerships and marriages of convenience with the top players in the world's oil market. The consensus today is that Russian oil companies are likely to boost production and exports (where capacity constraints are being relieved through the coming on stream of a number of pipelines) in the years ahead, even at the cost of lower oil prices. They are also likely to capture much of the share of growth in demand in countries like China, India and,

increasingly, through joint ventures, the US. Furthermore, Russia remains the world's largest gas exporter, dwarfing the combined output of the US and the EU, plus Norway and Saudi Arabia.

While the above has all the elements of a compelling investment story, it will take more than a single multibillion dollar investment to erase many of the unpleasant memories of the 1990s. Every foreign investor is ready to agree with the statement that Russia today has a more stable economy and business environment than Russia five or more years ago. But the conditions are not yet in place for the sort of steady, large inflows that one has seen already for many years in the more successful transition economies of the region—Hungary, the Czech Republic and several of the other

future members of the EU. Also, while the energy sector is attractive for the reasons outlined above, other sectors are considerably less so and this is the bad news. More than a decade of study and observation has shown that high growth rates and rapid employment growth have been led by the small and medium-sized enterprises; in Russia they don't even have access to bank credit! So, while the BP story is a very good way to start 2003, there is much harder work ahead. This conclusion is not intended to depress the reader, but to alert him to the boundless possibilities for growth and the main reason why Russia is likely to remain one of the "bright" spots in the global economy for investors with a healthy tolerance for risk.



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